No. 12,965

IN THE

United States Court of Appeals

For the Ninth Circuit

HAWAIIAN FREIGHT FORWARDERS, LTD.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A REHEARING.

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To the Honorable William Denman, Chief Judge, and to the Honorable Associate Judges of the United States Court of Appeals for the Ninth Circuit:

The petitioner corporation, feeling that the Court in its opinion filed May 5, 1952, inadvertently made clearly erroneous statements of law of far-reaching effect, and resulting in a gross injustice to petitioner, respectfully petitions the Court for a rehearing.

The essence of the opinion may be summarized briefly as follows:

1. "Person" or "Persons" as used in Section 112(b)(5) means natural persons and does not include entities.

2. Therefore the purpose of incorporating Section 112(b)(5) into Section 740(a)(1)(D) was to restrict the latter section to partnerships in which no change of membership had occurred.

3. The concept of partnerships adopted by Congress is such that any change in membership terminates the partnership; this accords with the Uniform Partnership Act.

Each of these predicates is clearly and demonstrably an erroneous statement of existing law, contrary to the statutes involved and the overwhelming weight of case authority, including cases of this Court and of the Supreme Court.

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1. "PERSONS", AS USED IN SECTION 112(b)(5), INCLUDES ENTITIES AS WELL AS NATURAL PERSONS.

This proposition is so clear as to require little amplification. Section 3797(a)(1) I.R.C. expressly defines "persons" as including entities. Regulations 111, Sect. 29.112(b)(5)-1 provides:

> "As used in Section 112(b)(5), the phrase 'one or more persons' includes individuals, trusts or estates, partnerships and corporations. (See Section 3797) * * *."

In addition to the cases cited in petitioner's reply brief, pages 6-7, see the opinion of this Court in *Halliburton, et al. v. Comm'r.*, 78 F. (2d) 265 (1935), involving an incorporation under 112(b)(5) by seven corporations and a partnership.

2. THE PURPOSE OF INCLUDING SECTION 112(b)(5) INTO SECTION 740(a)(1)(D) WAS NOT TO PRECLUDE CHANGES IN THE MEMBERSHIP OF A PARTNERSHIP; THE PURPOSE WAS TO EXCLUDE TAXABLE INCORPORATIONS.

As Section 112(b)(5) deals with entities as well as with individuals, there can be no implication from that section that an unimportant change in membership of a partnership was intended to prevent the application of Section 740(a)(1)(D). The obvious intendment of Section 740(a) was that tax-free incorporations (and only such) should qualify—all of the transactions specified are tax-free under various subdivisions of Section 112(b).[1] The necessary effect and obvious purpose of the requirement of a 112(b)(5) transaction is identical—the transfer to the corporation must be tax-free to qualify under Section 740(a)(1)(D).

The latter section nowhere refers to transfers *by the partners;* it nowhere refers to property *of the partners* used by the partnership: It refers only to *properties of a partnership.* This treats a partnership as something more than the group of individuals who are its

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[1]See *Siedman, Legislative History of Excess Profits Tax Laws* 271-273.

If the transaction were one in which gain or loss was recognized the need for the remedy would largely be dissipated—the corporation would have a stepped-up basis for the assets, including good will, acquired. If petitioner could include the actual value of its good will in March, 1940, in the measure of its invested capital credit, it would have little need for relief. It cannot do this because the incorporation was tax-free under Section 112(b)(5).

members. It is a business unit which, as such, has property which may be transferred to a corporation.[2]

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3. THERE IS NO STATEMENT OF CONGRESSIONAL POLICY IN THE REVENUE CODE AND THERE IS NO PROVISION OF THE UNIFORM PARTNERSHIP ACT WHICH WOULD RESULT, UNDER THE CIRCUMSTANCES PRESENTED, IN TREATING HAWAIIAN FREIGHT ASSOCIATION AS A NEW PARTNERSHIP FOR THE PERIOD MARCH 8 TO MARCH 31, 1940, OR ANY PORTION THEREOF.

The Court's opinion (p. 5) concerning the statement of Congressional policy in the Internal Revenue Code is confusing. Sections 113(a)(13), 183, 187, 188, and 190 of that Code clearly treat a partnership as something different from its members. Under Section 3797(a)(2) it includes business organizations which are not trusts, estates or corporations. The fact that

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[2]As stated by *Little, Federal Income Taxation of Partnerships,* p. 298:

> "The courts generally agree that it is the partnership and not the individual partners who are the 'persons' transferring the assets and obtaining control of the corporation. Both the Court of Appeals for the District of Columbia and the Tax Court recognize the partnership as an entity for this purpose. In a somewhat surprising reversal of his usual insistence upon an application of the aggregate theory of partnerships, the Commissioner also apparently so recognizes the partnership. * * *."

In support, Little cites:

Labrot v. Burnet, 57 F. 2d 413 (C.A.D.C. 1932);
Schtam Corp. v. Com., 125 F. 2d 655 (C.A. 2, 1942), affirming 44 B.T.A. 258;
Halliburton v. Com., 78 F. 2d 265 (C.A. 9, 1935);
Earle v. Com., 38 F. 2d 965 (C.A. 1, 1930), affirming 15 B.T.A. 668;
Kessler v. U. S., 124 F. 2d 152 (C.A. 3, 1941);
G. C. M. 11,557, XII-1 C.B. 128;
Schmieg, Hungate and Kotzian, Inc., 27 B.T.A. 337.

Congress has expressly exempted partnerships as such from tax implies that partnerships would otherwise be taxed as such.

The case of *Heiner v. Mellon,* 304 U.S. 271, 58 Sup. Ct. 926 (1938) is distinctly in point on both phases of this problem. The Court there held (p. 929):[3]

> "The fact that the partnerships had been dissolved by Fritz's death before 1920 does not affect the liability of the Mellons as surviving partners for income taxes on their distributive shares of the net profits made in that year. * * * The business of A. Overholt & Co. did not terminate on Fritz's death. Although dissolved, the partnerships and the business continued, since, as stated in the Pennsylvania Uniform Partnership Act: 'On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed.' Throughout the year 1920 the business of selling stock on hand and deriving income therefrom was carried on precisely as it had been theretofore, and for the same purpose. * * *."

In a leading case on the subject it was held that the death of an *inactive* partner holding only a 20% interest did not even cause a dissolution under the Uniform Act, let alone a termination.

> *Zeibak v. Nasser* (1938), 12 Cal. (2d) 1, 82 P. (2d) 375.

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[3]To understand this case it is necessary to appreciate that under the Regulations as the same then stood, a partner realized gain or loss on the termination of a partnership just as would a corporate shareholder on the liquidation of a corporation. The Mellons were contending that the old partnership had been terminated by the death of Fritz and a new partnership created, and that they were entitled to utilize as the cost to the new partnership the fair market value of the assets at the time of termination of the old partnership.

In *California Employment Stabilization Commission v. Walters* (1944), 64 Cal. App. (2d) 554, 149 P. (2d) 17, it was held that the status of the partnership continued, because of the agreement of the partners, notwithstanding the withdrawal of two of them. Rules similar to those have been applied in other jurisdictions under the Uniform Act.[4]

Following *Heiner v. Mellon, supra,* the Courts in Federal Income tax cases, until the present opinion here involved, have quite consistently held that changes in partnership membership did not terminate the existing partnership and create a new one where the partners had otherwise agreed and in substance "the firm" continued.[5]

Regs. 111 Sect. 29.113(a)(13)-2 contain language with respect to partnership reorganizations which is directly contrary to the Court's position. In at least two cases what purported and were intended to be new

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[4]*Underdown v. Underdown* (1924), 279 Pa. St. 482, 124 A. 159; *Gerding v. Baier* (1923), 143 Md. 520, 122 A. 675.

[5]*Samuel Mnookin,* 12 T.C. 744 (1949), aff'd 184 F. 2d 89 (C.A. 8, 1950);
Robert E. Ford, 6 T.C. 499, Acq., 1946—2 C.B. 2;
Girard Trust Co. v. U. S., 182 F. 2d 921 (C.A. 3, 1950);
Henderson's Estate v. Com'r, 155 F. 2d 310 (C.A. 5, 1946);
Estate of Arron Lowenstein, 12 T.C. 694, aff'd sub nom. *First National Bank of Mobile, Ex'r v. Com'r,* 183 F. 2d 172 (C.A. 5, 1950);
Com'r v. Lehman, 165 F. 2d 383 (C.A. 2, 1948);
Ransohoff's, Inc., 9 T.C. 376;
Mary D. Walsh, 7 T.C. 205.

partnerships (following withdrawals) were held to be reorganizations of continuing partnerships.

Lester W. Fritz, 28 B.T.A. 408, affd. 76 F. (2d) 460 (C.A. 5, 1935);

Alphonso E. Bell Corp., B.T.A. Memo. Dec. C.C.H. No. 12585F (1942) aff'd on another point, 145 F. (2d) 157 (C.A. 9, 1944).

A holding that the old partnership was terminated and a new one created ignores substance and reality in favor of legal fictions not established as existing; it makes labels and characterizations that ignore the continuity of ownership by the firm, the continuity of the business of the firm under the same management until the corporation was organized and the firm assets transferred to it.

Lyeth v. Hoey, 305 U.S. 188, 59 S. Ct. 155, 159-160 (1938).

Petitioner concedes that in the case of a reorganization of a partnership such that either it or its continuing members have realized gain or loss for tax purposes, where there has actually or in real substance been a transfer from one firm to another, a new partnership has been created to succeed to the assets and continue the business. No such events here occurred. There was no transfer from an "old partnership" to a "new partnership"—an inactive partner ceased to have his financial interests—nothing more.

The petitioner acquired, through a tax free transfer, the assets, business and the management which had produced the prior profits and legally and equitably is entitled to use those profits as its standard of normal

earnings. The expressed policy of Congress in enacting the statute confirms this.

Dated, San Francisco, California,
June 4, 1952.

Respectfully submitted,
LOUIS JANIN,
HAROLD E. HAVEN,
MELVIN H. MORGAN,
Counsel for Petitioner.

Certificate of Counsel.

Louis Janin and Melvin H. Morgan, two of counsel for petitioner, hereby certifiy that the foregoing petition for rehearing (prepared by them) is not interposed for purposes of delay but, in the opinion of such counsel, is meritorious and entitled to the fullest consideration of the Court.

Dated, San Francisco, California,
June 4, 1952.

Louis Janin,
Melvin H. Morgan,
Counsel for Petitioner.